Corporate Income Tax Audits – Recent Cases and Current Trends
Agenda

• Recent U.S. Supreme Court Developments

• Cost-of-performance vs. Market Sourcing

• Alternative Apportionment

• MTC Compact Litigation

• Other Developments
Recent U.S. Supreme Court Developments
Apportioning the Personal Income Tax

- **Comptroller of the Treasury v. Wynne, 575 U.S. __ (2015).**
  - **Question Presented:** Does the U.S. Constitution prohibit a state from taxing all of the income of its residents -- wherever earned -- by requiring a credit for taxes paid on income earned in other states?
  - **Answer:** Yes. Taxing individual residents of a state on their worldwide income without the state apportioning or providing credit for taxes paid to other states unconstitutionally creates the risk of multiple taxation, in violation of the dormant Commerce Clause’s prohibition against unfairly apportioned taxes.
    - How far does this apply – sales/use taxes, piggyback and non-piggyback local income taxes, etc.?
Cost of Performance vs. Market Sourcing
Introduction – Sourcing

- **Two Broad Sourcing Categories**
  - **Cost of Performance** = sales from services sourced to this state if (a) the income-producing activity is performed in this state; or (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on cost of performance
  - **Market** = sales from services sourced to this state if the taxpayer’s market for the sale is in this state

- **Trends**
  - Cost of Performance = 28 states
  - Market Sourcing = 19 states
  - Recent Developments: Since 2008 – AL, AZ, CA, IL, MA, OK, UT, WA have shifted to market-based sourcing regimes
Cost of Performance Sourcing: AT&T Cases

• **AT&T Corp. v. Comm’r of Revenue, Mass. ATB 2011-524 (June 8, 2011), aff’d, No. 11-P-1462 (Mass. App. Ct. 2012)**
  - MA decided *in favor* of AT&T regarding whether receipts from its interstate and international telecommunication services should be included in the MA sales factor numerator
  - Adopted operational approach – income producing activity includes entire business of providing national telecom network

• **AT&T Corp. v. Dep’t of Revenue, Oregon Tax Court, TC 4814 (June 28, 2011)**
  - Decision *against* AT&T on same issue
  - Adopted transactional approach – income producing activity consists of each individual telephone call transaction, and evidence of costs for each call must be demonstrated
Cost of Performance Sourcing: New York

  - New York Tax Law sources “service” receipts based on location of performance and “other business” receipts based on market
  - ALJ held that travel reservation facilitation receipts and online advertising receipts were “service” receipts and must be sourced to the location where the services were performed
  - Taxpayer demonstrated that the services were performed at its headquarters, data centers, and call centers rather than the location of its customers’ modems
  - ALJ rejected the Department’s position that a “service” requires human involvement at the time the transaction is consummated
Cost of Performance Sourcing: Other States

- Trend of reaching market-based conclusions in cost-of-performance states by focusing on the final act provided to customers
  - South Carolina: DIRECTV, Inc. v. S.C. Dep’t of Revenue, Dkt. No. 14-ALJ-17-0158-CC (S.C. Admin. Law Ct. May 12, 2015) (the primary income-producing activity of a satellite video provider includes customer subscriptions and delivery of signal into customers’ homes)
  - Florida: Fla. TAA 12C1-006 (May 17, 2012) (Online courses were sourced to the location of the student and not where costs of performance were incurred); Fla. TAA 13C1-004 (May 21, 2013) (Receipts from licensing television programming to cable operators were sourced to the location of the operator/customer)
  - Texas: Comptroller’s Decision No. 104,224 (May 17, 2013) (receipts derived from satellite service are sourced to location of set top box, because customers contract with provider to receive video programming in their homes)
Market Sourcing

• Trend towards “market” sourcing rules for sourcing sales of services and intangibles
  ▪ Market sourcing rules attempt to source sales to the location of the customer
  ▪ States vary widely in how they define “market”
  ▪ Limited guidance by states on how to source sales

• Recent states adopting market sourcing include:
  ▪ Kentucky HB 132 (eff. 1/1/2016)
  ▪ Missouri HB 321/SB 19 (eff. 8/28/2013)
  ▪ Pennsylvania HB 485 (eff. tax years after 12/31/2013)
  ▪ District of Columbia 2015 BSA (eff. 1/1/2015)
Market Sourcing: Identifying the “Market”

• What is the taxpayer’s “market”?
  ▪ The customer’s actual location (e.g., OK, MD)
    ▪ Customer’s billing address
    ▪ Where purchase order issued
    ▪ Location of commercial domicile (principle place of business, nerve center, etc.)
  ▪ Location where the customer receives the benefit of the services provided (e.g., GA, IA, MI)
    ▪ Can be difficult to determine when customer is multistate business
  ▪ Reasonable approximation?
Market Sourcing: Identifying the “Market”

• Intangibles difficult to source because they have no geographical location or scope

• Many states break intangibles into:
  ▪ Sale of intangibles
  ▪ Income/royalties from license of intangible

• “Market” for sale of intangibles
  ▪ CT sources the receipt to the state from which the intangible asset is managed or controlled
  ▪ TX sources the receipt to the location of the payer
  ▪ WI sources receipt to WI if the buyer uses the intangible in the regular course of business at a WI location and WI will divide the income proportionally among states if the intangible is used at locations within and without WI
Market Sourcing: Identifying the “Market”

• “Market” for the licensing of an intangible
  ▪ CT, GA source receipts to location where the intangible is used, based on the proportion of the use taking place within the state
  ▪ MN sources to location of use of intangible, but provides guidance on where the “use” occurs: use of the intangible occurs in the state if the purchaser of the intangible property used the property in the regular course of its business operations in MN

• Throw-out
  ▪ Some states throw out income if it cannot be determined where the intangible was “used”
    ▪ MN, MI (for the MBT)
Alternative Apportionment
Alternative Apportionment – Background

• UDITPA Section 18 provides that if a state’s statutory method does not “fairly represent the extent of the taxpayer’s business activity in [the] state, the taxpayer may petition for or the [Department] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:
  ▪ (a) Separate accounting;
  ▪ (b) The exclusion of one or more of the factors;
  ▪ (c) The inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in this state; or
  ▪ (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income
Alternative Apportionment – Background

• **MTC Regulation IV.18(a) provides:**
  - **Original**: “…only in specific cases where unusual fact situations (which usually will be unique and non-recurring) produce incongruous results…”
  - **As Amended**: “…only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results…”

• However, states have increasingly applied alternative apportionment methods where the statutory apportionment rules result in less income apportioned to the state than the state believes is fair.
Invoking Alternative Apportionment

Burden of proof on the party (tax authority or taxpayer) seeking to diverge from the standard apportionment formula to prove that (1) distortion exists, and (2) a proposed alternative method is reasonable.
Distortion

• Constitutional “Gross Distortion”
  - *Twentieth Century-Fox Films v. Dep’t of Revenue, 700 P.2d 1035 (Ore. 1985)*
    - Court held that alternative apportionment is only applicable to remedy unconstitutional situations or where the UDITPA formula does not fairly represent the business activity of the taxpayer
  - Illinois regulations provide:
    - “… An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. However, if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate alternative method is appropriate.” 86 Ill. Adm. Code § 100.3390(c)
Distortion

- California Standard for Distortion - *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Cal. 2006)
  - Qualitative Analysis
    - The qualitative analysis examines the type of business conducted by the taxpayer in comparison to any activity that may create distortion
  - Quantitative Analysis
    - Quantitative distortion may be demonstrated by various methods, including separate accounting, comparison of profit margins, comparison of apportionment percentages, comparison of income and gross receipts from various activities, etc.
    - Profit Margin from a taxpayer’s primary business is several orders of magnitude different from the profit margin on the treasury function
Distortion

  - Illustrates the difficulty in obtaining alternative apportionment
  - Taxpayer requested alternative apportionment formula as it pays an income tax on over 150% of its federal consolidated income
  - Department denied request and noted that the fact taxpayer was filing on different bases contributed to why the taxpayer paid tax on more than 100%; The taxpayer reaped the benefit of including affiliated group in apportionment factors
  - DOR determined that a taxpayer and its two affiliated entities were not required to report their income using a separate accounting method because the Department’s audit staff failed to prove the standard apportionment formula did not fairly reflect the taxpayer’s business activities in Indiana
Reasonable Alternative

- If the taxpayer or the Department of Revenue successfully argues that distortion exists in the application of the statutory apportionment formula, it must then show that there is a reasonable alternative.

UDITPA § 18 – Alternatives

- Separate accounting;
- The exclusion of any one or more of the factors;
- The inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in this state; or
- The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.
Reasonable Alternative – South Carolina

- Combined Reporting vs. Separate Accounting
  - *Media General, Inc. et al. v. S.C. Dep’t of Revenue*, 694 S.E.2d 525 (S. Car. 2010)
    - DOR agreed with taxpayer that the state’s apportionment was not fairly reflecting the taxpayer’s activity in the state, but held combined reporting was not allowed as a method of alternative apportionment to fix the distortion
    - Court held combined reporting could be used as an alternative apportionment method
    - DOR used alternative apportionment that imposed separate accounting
    - Court held the DOR failed to meet its burden of proof in showing that the statutory apportionment method resulted in distortion
Reasonable Alternative – South Carolina

  - Will follow Carmax decision - preponderance burden on the moving party
  - DOR will not limit use of alternative apportionment to unique or nonrecurring factual situations
  - DOR will generally use a water’s edge method; Finngan rule for calculating sales factor
  - DOR will not apply understatement penalties or extend SOL for understatements
  - Will combined reporting be the primary, or only, alternative method use by the DOR? Joyce? Worldwide combined group?
Reasonable Alternative – Tennessee

  - Vodafone (based in California) held a 45% interest in a partnership (Cello) that operated Verizon Wireless
  - Vodafone calculated its apportionment formula by using a pay-per-use or primary-place of use methodology
    - Filed a refund claim and argued that it was not subject to Tennessee franchise tax
    - Amended complaint argued that a COP analysis should be used instead – resulted in 89% reduction in tax liability
  - Court of Appeals determined the Commissioner properly required Vodafone to apportion sales using market-based sourcing instead of the statutory cost of performance method
  - The Tennessee Supreme Court granted cert. on Nov. 20, 2014
Reasonable Alternative or Disguised Deviation from Statutory Method?

• Adjustments to Sales Factor
  - Indiana Dept. of Rev. Letter of Finding No. 02-20130238 (Sept. 1, 2013) (Out-of-state information service provider must source in a market-sourcing-like manner, even though the majority of its costs were incurred outside Indiana)
  - Indiana State Dep’t of Revenue, Letter of Findings Nos. 02-20130047 and 02-20130048 (Jan. 1, 2014) (Multistate corporation and its subsidiary were not entitled to source their receipts from franchise agreements based on COP)
Reasonable Alternative or Disguised Deviation from Statutory Method?

• Disguised Deviation from Statutory Method?
  - South Carolina law required that the “total gross receipts” from sales be included in the sales factor.
  - The Court of Appeals held that receipts other than interest from sales of securities are not “receipts” and should be excluded from sales factor because as a matter of law, including such receipts in the sales factor does not fairly represent the taxpayers business activities in the state.
  - Compare with *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Cal. 2006).
    - Court found that inclusion of Microsoft’s gross receipts from its treasury function in its sales factor was distortive as a matter of fact.
Reasonable Alternative or Disguised Deviation from Statutory Method?

• Disguised Deviation from Statutory Method?
    ▪ South Carolina law applies different apportionment methods to taxpayers engaged in manufacturing, i.e., dealing in tangible personal property, and taxpayers providing a service
      ▪ “Manufacturing” and “tangible personal property” are not defined
      ▪ The Court of Appeals held that even though the provision of electricity was a service, the taxpayer was a manufacturer based on the plain meaning of the term because applying the apportionment method applicable to service providers would not “reasonably represent the taxpayer’s business” in the state, as a matter of law
Burden of Proof: Who has it?

- **Equifax, Inc. v. Miss. Dep’t of Revenue, 125 So.3d 36 (Miss. 2013)**
  - DOR applied an alternative apportionment method utilizing market-based sourcing rather than the statutory COP method
  - Mississippi Supreme Court reversed the Court of Appeals and held that the **taxpayer** bears the burden to prove that the alternative apportionment method **proposed by the DOR** was arbitrary and unreasonable
    - Court’s review of Department’s imposition of alternative methodology is limited to whether that decision was supported by substantial evidence or that it was arbitrary and capricious
    - Result that taxpayer may find it much more difficult to challenge Department’s assertion of alternative methodology
Burden of Proof: Who has it?

- Legislative Response to *Equifax* (HB 799) (Eff. 1/1/15)
  - Places burden of proof on party invoking alternative apportionment method to prove by a *preponderance of the evidence* that:
    - Statutory method does not fairly represent activity in state; *and*
    - Selected method more fairly represents that activity than any other reasonable method available
  - Requires that alternative apportionment be invoked only in “limited and unique, nonrecurring circumstances”
  - Prohibits DOR from invoking forced combination until regulations have been promulgated
  - No penalties from forced combination unless DOR finds no reasonable basis or nontax business purpose
Alternative Apportionment: Practical Considerations

• Majority of states require taxpayer to petition or request an alternative apportionment formula in advance (e.g., CA, ID, MI)
• Other states require that pre-approval and/or alternative apportionment be in the form of a refund/amended return (e.g., IL, NM)
• Violation of State Administrative Procedures Act?
• The broad application of Alternative Apportionment may violate state administrative procedures acts that limit a state agency’s ability to rely on ad hoc adjudication when the adoption of a rule is more appropriate
• Separation of Powers arguments?
MTC Compact Litigation
MTC Compact Litigation


- **IBM v. Michigan Dep’t of Tax., 852 N.W.2d 865 (Mich. Jul. 14, 2014)** (two statutory apportionment provisions could be reconciled and three-factor MTC election still available for both MBT taxes; did not address “compact clause” issue).
  - In September 2014, legislation signed retroactively repealing Compact, stating multistate corporations not entitled to use MTC’s income-apportionment formula as of Jan. 1, 2008. MDOT motion for reconsideration denied Nov. 15, 2014.

MTC Election


- *Graphic Packaging Corp. v. Combs*, No. D-1-GN-12-003038 (Travis Count. Dist. Ct., order issued Jan. 15, 2014) (court denied the application of the MTC three-factor apportionment formula)


Other Developments
Mississippi Rules Dividend Exclusion Statute Discriminatory

  - Mississippi’s dividend exclusion statute excluded from taxpayers’ gross income intercompany dividends received from domestic affiliates doing business and filing income tax returns in Mississippi.
  - The court held that the statute violated the Commerce Clause because it facially discriminated against interstate commerce.
    - The statute denied taxpayers a tax benefit “based solely upon the choice of the taxpayer and its subsidiaries not to locate any operations in Mississippi or to file a Mississippi income tax return.”
  - The court struck the discriminatory limitation and granted the tax benefit to the taxpayer for the years at issue.
Questions?

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